

CITIES SERVICE OIL AND GAS CORP.

IBLA 87-438

Decided November 24, 1989

Appeal from a decision of the Director, Minerals Management Service, affirming an order assessing additional royalties on natural gas liquid products extracted from gas produced under Outer Continental Shelf oil and gas leases. MMS 86-0169-OCS.

Set aside and remanded.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties -- Oil and Gas Leases: Royalties: Natural Gas Liquid Products -- Outer Continental Shelf Lands Act: Oil and Gas Leases

When the lessee's price for natural gas liquid products is less than the minimum yardstick value established in accordance with the Procedure Paper on Natural Gas Liquid Products Valuation, it is improper for MMS to utilize the average of the high and low prices in the yardstick range to determine the value of production. The yardstick minimum should be the price employed in such a situation.

APPEARANCES: Patricia A. Patten, Esq., Tulsa, Oklahoma, for Cities Service Oil and Gas Corporation; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HARRIS

Cities Service Oil and Gas Corporation (Cities Service) has appealed from a January 22, 1987, decision of the Director, Minerals Management Service (MMS), denying its appeal from an order of the Regional Manager, Tulsa Regional Compliance Office, Royalty Management Program (RMP), MMS, dated March 6, 1986, assessing additional royalties of \$ 63,013.49 for natural gas liquid products (NGLP's) extracted from gas produced from Federal offshore leases and processed at the Yscloskey gas processing plant (Yscloskey) in Louisiana during the period January 1980 through December 1982.

The assessment followed an audit by the Office of Inspector General (OIG) of the Department of the Interior. OIG based its royalty valuation on the methodology set forth in the "Procedure Paper on Natural Gas Liquid

Products Valuation" (Procedure Paper) issued by the Royalty Valuation and Standards Division of the Royalty Compliance Division of MMS on December 14, 1984, and revised on February 25, 1985.

The Director, MMS, described the utilization of the Procedure Paper in the valuation of the NGLP's, as follows:

In an effort to develop a yardstick for determining the reasonableness of a reported royalty value for NGLP, the RMP considered:

- NGLP sales contracts
- Prices received by lessees
- Department of Energy prices, and
- Commercially available NGLP Bulletins

A study of these sources concluded that commercial price bulletins represent the best available price source and in most instances are indicative of NGLP fair market value. Under the procedure paper, to establish a yardstick to compare to the lessee's reported prices, RMP will take the highest and lowest published prices for the month from the appropriate bulletin. If the reported price falls within this range, the value will normally be accepted by RMP for royalty valuation purposes. As a matter of general practice, if the prices used to calculate royalties fall below the range, a minimum acceptable to RMP will be determined by developing an average value from the lowest and highest prices in the range.

There are several exceptions and qualifications to this practice. For example, the price received under a true arm's-length contract establishing an NGLP price will normally be accepted for royalty purposes. \* \* \* Similarly, if a lessee has a non-arm's-length contract which established an NGLP price and the lessee can show that the contract has characteristics similar to arm's-length contracts which represent fair market value, Minerals Management Service (MMS) will normally accept the non-arm's-length contract price for royalty valuation purposes.

(Director's Decision at 3). The Procedure Paper also listed suggested spot price locations for various producing areas and the appropriate bulletins to be used as price sources. For the NGLP's at issue in this case, Mt. Belvieu, Texas, was the suggested market.

In the March 6, 1986, order, RMP found that Cities Service's NGLP royalty prices for natural gasoline and butanes were based on intra-company transfer prices which were lower than the lowest published market prices at Mt. Belvieu. Additional royalties applicable to propane production were included "because documentation supporting Cities' propane prices was not provided to OIG."

The Director, MMS, affirmed the decision of RMP. The Director noted that the bulk of the deficiency assessment was based on revisions in the royalty value of propane. Although Cities Service had claimed that its propane production from Yscloskey was sold to outside parties, the Director found that no documentation supporting this claim had been furnished to the auditors, nor presented on appeal. The Director cited appellant's failure to provide proof that the propane was sold pursuant to an arm's-length contract or a non-arm's-length contract having characteristics similar to an arm's-length contract. <sup>1/</sup>

[1] On appeal to this Board, Cities Service raises a number of challenges to MMS' development of the Procedure Paper and also to its use by MMS to value production during the period in question. <sup>2/</sup> The Board has rejected similar challenges in a number of recent decisions. Amoco Production Co., 112 IBLA 77 (1989); Union Oil Co., 111 IBLA 369 (1989); Shell Offshore Inc., 111 IBLA 350 (1989); Conoco Oil Co., 110 IBLA 232 (1989). However, in each of those cases we found that MMS erred in following the guidance of the Procedure Paper by establishing the value of production as the average of the yardstick values, when the lessee's price fell below the yardstick floor price. In Conoco, Inc., 110 IBLA at 244, we explained as follows:

[I]n the present case a price falling below the floor value is raised not to the floor value, but to a price computed by averaging the floor value with the high spot market price, in effect making the average the floor value. We find that the acceptance of any settlement price within the range of the low to the high spot market price as constituting fair market value is inconsistent with requiring payment of the average spot market price where lessee's settlement price is less than the floor value. While the obligation of MMS to value production at no less than the gross proceeds realized by the lessee may lead to a valuation in excess of the fair market value/floor value where this

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<sup>1/</sup> The Procedure Paper at page 4 defines an arm's-length contract as follows:

"'Arm's-length contract' is a contract or agreement that was freely arrived at in the open market place between independent, non-affiliated parties of adverse economic interests. The contract did not involve any considerations other than the sale of NGLP's and was prudently negotiated under the facts and circumstances existing at the time."

<sup>2/</sup> Cities Service argues that its valuation was proper and that MMS should be estopped from applying the Procedure Paper retroactively to determine otherwise. It also claims that the Procedure Paper was improperly developed without the utilization of any of the procedural safeguards required by provisions of the Administrative Procedure Act, 5 U.S.C. § 553 (1982). It argues that the values it reported were well within the Secretary's discretion to accept.

is reflective of proceeds received by the lessee, the fair market value is the standard at issue in this case where the NGLP were used internally and not marketed. If the average spot market price rather than the floor price constituted fair market value, then MMS would be without authority under the statute and regulation to accept royalty settlement prices as low as the floor price as the Procedure Paper indicates MMS has done.

Likewise, in this case MMS followed the same procedure, and for the same reasons, we must set aside the Director's decision and remand the case for recomputation of the additional royalties due.

Next, we turn to Cities Service's argument that MMS has failed to recognize its arm's-length contracts. There is no evidence that appellant submitted any arm's-length contracts to MMS. However, with its statement of reasons, appellant has attached copies of four documents, designated as Exhibits A-D: (1) an "NGL Exchange Agreement" between Cities Service and Shell Oil Company which Cities Service states "was used to supply Dixie Pipe Line terminal sales from April 1979 until October 1980"; (b) an "NGL Exchange Agreement" between Cities Service NGL Inc. and Exxon Company, U.S.A., allegedly in existence since May 1982, as evidence of an arm's-length sale of propane; (c) an "NGL Exchange Agreement" between Cities Service and Shell, dated December 6, 1979, for propane; and (d) an October 14, 1982, "Railroad Freight Bill for freight propane from Yscloskey to Hattiesburg for later sale into Dixie terminal" (Statement of Reasons at 16).

Cities Service makes no attempt to explain the significance of these documents. Cities Service does, however, criticize a finding by the Director at page 7 of his decision that Cities Service's prices "cannot be considered as representative of fair market value" because "it uses published prices less marketing costs" and marketing costs are expressly excluded as royalty deductions. Cities Service states that "marketing costs deducted from royalty include transportation and trade differential charges which are allowed" (Statement of Reasons at 16).

In its answer, MMS does not address the documents; it simply states that 30 CFR 206.106(b), which provides in pertinent part that "no allowance shall be made for \* \* \* other expenses incidental to marketing," prevents it from giving appellant credit for marketing expenses. It is not clear, however, that Cities Service is seeking credit for marketing expenses, rather its point seems to be that "marketing expenses" in this case actually included certain deductible expenses.

The real question presented, however, is whether Cities Service had, during the period in question, arm's-length agreements which establish fair market value. That is something that we cannot determine based on the limited record that we have before us. Clearly, by failing to present any evidence regarding the arm's-length nature of agreements with third parties to the auditors or to the Director, MMS, on appeal to him, Cities Service precluded any favorable ruling on that question. Nevertheless, it has presented certain documents on appeal, and since we are

remanding this case for recalculation of the additional royalty on other grounds, we believe it is appropriate, under the circumstances, for MMS to review the documentation submitted by Cities Service to the Board. <sup>3/</sup> During its review, MMS should be mindful of our ruling in Amoco Production Co., 112 IBLA at 84 that

the fact that third party contracts included a deduction for marketing costs does not discredit the arm's-length nature of those contracts or establish that the price is not fair market value. In accordance with the Procedure Paper, MMS will normally accept the non-arm's-length contract price for royalty purposes where the contract has characteristics similar to arm's-length contracts which represent fair market value. Clearly, however, where that price reflects deductions that may not be made in determining value for Federal royalty purposes, such deductions may be added to the contract price to derive the value of production for royalty computation.

Thus, if following review of appellant's third-party agreements, MMS determines that, but for the fact that marketing costs have been deducted, they satisfy the Procedure Paper definition of arm's-length contracts, our rationale from the Amoco case would be applicable.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is set aside and the case remanded for further action consistent with this opinion.

Bruce R. Harris  
Administrative Judge

I concur:

Wm. Philip Horton  
Chief Administrative Judge.

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<sup>3/</sup> The procedure adopted in this case should not be regarded as encouraging appellants to delay the submission of documentation to support arguments presented.

